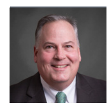
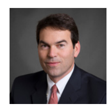
How to Improve Your Investment Returns Through Tax-Loss Harvesting

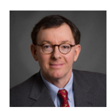
Strategically selling holdings at a loss can help reduce your portfolio's tax liability.



Roger Young, CFP®
Thought Leadership Director



Mark Weigman
Head of Private Asset Management



Don Peters
Manager of the T. Rowe Price Tax-Efficient Equity Fund

KEY INSIGHTS

- Tax-loss harvesting can be a valuable strategy to reduce your capital gains taxes.
- Tax considerations are important, but they should not drive your decisions at the expense of a sound investment strategy.
- Keep in mind the rules related to tax-loss harvesting, including wash sales and recognition of capital gains.

Tax-loss harvesting is a potentially valuable strategy involving selling certain positions in a portfolio at a loss. Those losses would then typically be used to offset gains realized elsewhere in the portfolio, including those from sales of investments or capital gain distributions from mutual funds or exchange-traded funds (ETFs).

The concept is part of a broader strategy in which investors look to accelerate losses and delay realized gains in their taxable accounts. This delays the payment of taxes, keeping more assets available for potential growth. With a flexible and intelligent strategy, investors can use tax-loss harvesting to reduce their tax liability for the year.

Consider how this approach might work using the following hypothetical example of two single filers with identical portfolios, each of whom earns $120,000 a year. John and Jane are both in the 24% tax bracket for ordinary income and short-term capital gains, with a 15% tax rate on long-term capital gains. For the purpose of this example,

What Is Tax-Loss Harvesting?

Tax-loss harvesting involves strategically selling securities to realize a loss, usually in order to offset either short-term or long-term capital gains. Since tax rates on short-term gains are generally higher, offsetting those gains is particularly valuable.

The Tax Benefits of Tax-Loss Harvesting

	JOHN (Without Tax-Loss Harvesting)	JANE (With Tax-Loss Harvesting)
Short-term capital gains	$10,000	$10,000
Tax-loss harvest	$0	$5,000
Tax liability from short-term gains	$10,000 x 24% = **$2,400**	$5,000 x 24% = **$1,200**
Long-term capital gains	$50,000	$50,000
Tax-loss harvest	$0	$15,000
Tax liability from long-term gains	$50,000 x 15% = **$7,500**	$35,000 x 15% = **$5,250**
TOTAL TAX LIABILITY FROM CAPITAL GAINS	**$9,900**	**$6,450**

let's say they each have realized a net total of $50,000 of long-term capital gains and $10,000 in short-term gains through a variety of trades in the current tax year. Their respective portfolios also include investments in a mutual fund they've held for many years that have declined in value by $15,000, as well as an individual stock holding that has lost $5,000 in value over the six months since they each bought it. John ignores the potential strategy for harvesting losses and faces a tax liability of $9,900 in his portfolio. By comparison, Jane harvests those losses and reduces her tax bill by $3,450. (See "The Tax Benefits of Tax-Loss Harvesting.") While John may be able to benefit from those losses in subsequent years, Jane gets the cash savings sooner.

Keys to proper tax harvesting

Selling a few underperforming holdings to save thousands in taxes may seem like a relatively easy choice, but there are many factors that should go into a decision to pursue tax-loss harvesting. "Taxes should not be the first thing you think about when choosing what to buy and sell," explains Roger Young, CFP®, a thought leadership director with T. Rowe Price. "Don't let tax reduction techniques derail your overall investment strategy." As with any strategy, there are several key elements to keep in mind:

Focus on the fundamentals. Tax-loss harvesting is just one tool in service of your broader investment strategy. Investment fundamentals, such as remaining focused on the long term, are more important overall than short-term tax considerations. Ultimately, you want to make sure any tax-loss harvesting activities do not alter fundamental elements of your portfolio, such as your asset allocation and risk exposure. In addition, you don't want to sell a position unless you can invest the proceeds in something with better expected returns.

Be alert for opportunities. Many investors assume tax-loss harvesting should take place in December, along with the rest of their year-end tax planning. This is also the time of year when investors typically receive information about dividend and gain distributions from their funds. However, tax-loss harvesting can be employed throughout the year. Of course, it can be difficult for individual investors to monitor their investments, and the potential tax consequences, throughout the year. If you can make time for this strategy, look for material losses—for example, 10% or more—to make tax-loss harvesting worth the effort and to avoid trading based on day-to-day volatility.

Consider losses across asset types. Tax-loss harvesting is not limited to

individual stocks; if you have a taxable account that contains mutual funds or ETFs with losses, it's worth considering a sale of those holdings as well. Just be careful when selling funds, as doing so can significantly alter your asset allocation. If you purchase another fund to keep your allocation aligned with your original allocation strategy, you must be careful not to invest in a fund that is "substantially identical" to the one you just sold; otherwise, you will run afoul of the IRS's wash sale rule. (See "Understanding the Wash Sale Rule.") Harvesting a loss in a fund could also create an opportunity to replace it with a more tax-efficient fund.

Cash can be a useful tool. Holding a cash position within a portfolio can be useful to take advantage of strategic opportunities. If an investor doesn't want to liquidate a holding that has a loss, they could use their cash to increase their holdings temporarily and then consider selling to take losses (if still applicable) after 31 days to avoid the wash sale rule. (Remember that the market's moves within those 31 days are unpredictable.)

Be tactical about account types. A portfolio that includes both taxable and tax-advantaged accounts—such as individual retirement accounts (IRAs)—can present additional opportunities for greater tax efficiency. "For example, you might be a little quicker to take profits in an IRA and to recognize losses in the taxable account," says Mark Weigman, head of Private Asset Management at T. Rowe Price. "Having both account

Understanding the Wash Sale Rule

The rule prevents deducting a loss in certain situations.

The IRS wash sale rule is in place to discourage transactions made purely for tax purposes. A wash sale occurs when you sell or trade stock or securities at a loss and buy "substantially identical" stock or securities within 30 days before or after the sale. If you have a wash sale, the capital loss is not deductible that year. The rule still applies if you buy related securities, such as call options on a stock instead of the stock itself. In addition, you don't get around the rule if you make the purchase in your Traditional IRA or Roth IRA after selling the holding in your taxable account.

For example, if you sold shares of a large-cap mutual fund at a loss on April 1, 2023, you would not be able to take the loss on your tax return if you purchase additional shares of the same (or a substantially identical) large-cap mutual fund on or before May 1, 2023 (30 days later). The definition of "substantially identical" depends on the facts and circumstances. The shares of two corporations are generally not considered to be substantially identical even if they are in the same industry segment. Similarly, two mutual funds tracking the same benchmark but advised by different investment advisors are generally not considered substantially identical. In both cases, however, there are exceptions, and you should always discuss with your tax professional.

If you do have a wash sale event, the rules do not permanently prevent a deductible loss. The disallowed loss simply increases your cost basis in the new holding. The rule, therefore, delays any tax efficiency benefits from realizing the loss, which generally defeats the purpose of a tax-loss harvesting transaction.

types adds some flexibility to the strategy." The funds in a Traditional IRA aren't taxed until the money is withdrawn in retirement, and any gains you realize in those accounts do not trigger a capital gains tax liability.

Capital loss carryovers and other factors

There are additional caveats beyond ensuring that you keep your fundamental investment strategy intact. Complicated rules involving wash sales, loss carryovers, and short- versus long-term gains may affect results of the strategy. This is why T. Rowe Price recommends consulting with a tax professional before pursuing a tax-loss harvesting strategy. Doing so is especially important if you consider purchasing a different investment in order to maintain an appropriate asset allocation. The tax professional can help you understand the wash sale rule and avoid unpleasant surprises.

It's also important to understand what to do if your losses outweigh your realized investment gains. Deductible net capital losses are limited to $3,000 per year ($1,500 if married filing separately), but excess losses can be carried forward to later years indefinitely.

Another consideration for investors is how to treat dividends and distributions in their taxable accounts. Dividend distributions often occur near the end of the year. Many investors have set up automatic dividend reinvestment and may forget that those shares acquired through dividend reinvestment may create wash sales. By having dividends and interest paid out in cash rather than reinvesting them, it is easier to avoid triggering the wash sale rules in a tax-loss harvesting strategy. However, this approach also requires diligence to ensure that cash is then invested in a manner that is aligned with your overall investment strategy. "You don't want to build up too much cash in your portfolio, given its limited growth potential," says Young.

Nothing automatic about selling a position

Selling positions with losses requires judgment; it's not something to do automatically, and it is not without risk. (See "A Portfolio Manager's Perspective.") While stocks or entire sectors can go out of favor, that doesn't necessarily make them bad investments. Missing out on a recovery could potentially cost more in forgone gains than it saves in taxes. When executed successfully, however, a tax-loss harvesting strategy can help investors minimize their current capital gains taxes. For most people, delaying taxes is wise—and that is what a tax-loss harvesting strategy accomplishes.

A Portfolio Manager's Perspective

As manager of the T. Rowe Price Tax-Efficient Equity Fund, Don Peters regularly employs tax-loss harvesting strategies.

Tax-loss harvesting is an important component of the portfolio management strategy employed by Don Peters, manager of the T. Rowe Price Tax-Efficient Equity Fund (PREFX). However, he applies a great deal of judgment and experience to the question of whether to sell a particular security to realize a loss.

Sometimes, Peters has a strong conviction in a holding and is unwilling to reduce or liquidate the position, even for a limited time. (Peters is subject to the same wash sale rules as individual investors.) Other times, he may be indifferent between two opportunities. For example, there could be another company with similar growth potential in the same industry. In that case, taking the tax loss and purchasing the other stock is advantageous.

"I consider whether our initial thesis on a holding is still intact," Peters says. "If conditions have changed, I am willing to recognize I was wrong and consider taking a loss. Investing requires some humility—omniscience is in short supply."

Peters typically focuses on a tax-loss harvesting strategy in the second half of each quarter, after many companies have reported their quarterly earnings. That way, he is less likely to be constrained by wash sale rules during earnings season. Since losses can be carried forward indefinitely, he looks for harvesting opportunities every year and not just in years with realized gains. Just remember that most individual investors will not have the time or resources that Peters and other professional portfolio managers can bring to bear to implement this strategy.

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